

States Should Decouple From New Business Interest Expense Limit

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In this report, the authors discuss the new IRC section 163(j) business interest expense limitation and recommend that states decouple from this provision.

The Tax Cuts and Jobs Act (P.L. 115-97) modified the IRC to add a new limitation on the ability of a taxpayer to deduct business interest expense, with any disallowed interest expense suspended and carried forward indefinitely for use in future years. Implementing this new business expense limitation at the state level will be exceedingly complex; accordingly, it may make sense for states to decouple from this new limitation.

Computation of the New Federal Interest Expense Limitation

At the outset, it must be pointed out that the business interest expense limitation in IRC section 163(j) was enacted as an anti-earnings-stripping tool that was meant to address the supposed propensity for multinational taxpayers to incur interest expense within the United States in order to reap a higher tax benefit for deductions used within the United States; the new provision is similar to a rule set out by the OECD as part of its base erosion and profit-shifting initiative.¹ There is no question that the business interest expense being disallowed under the new federal limitation is valid business interest expense; there are other federal rules that are designed to ensure that business interest expense is valid, such as the general federal rules concerning characterization of instruments as debt or equity.

The TCJA amended section 163(j) to provide that the amount of business interest expense that can be deducted by a taxpayer is limited to the sum of (1) the business interest income of the taxpayer for the tax year, (2) 30 percent of the taxpayer's adjusted taxable income (ATI) for the tax year (not less than zero), and (3) any floor plan financing interest — defined as motor vehicle inventory financing — of the taxpayer for the tax year.² Essentially, for most taxpayers this means that, to the extent the taxpayer has business interest expense that exceeds its business income, the taxpayer will be able to deduct such interest expense only to the extent that it does not exceed 30 percent of its ATI.

For tax years 2018 through 2021, a taxpayer's ATI is the taxpayer's federal taxable income (determined under IRC section 63) excluding: any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; any business interest expense or business interest income; the net operating loss deduction under IRC section 172; the deduction allowed under section 199A (the 20 percent deduction for some passthrough entities); and any deduction allowable for depreciation, amortization, or depletion. Thus, for tax years 2018 through 2021, ATI will reflect an entity's earnings before interest, taxes, depreciation, and amortization. Beginning in 2022, the computation of ATI will change, with deductions for depreciation, amortization, and depletion included in the computation of ATI. Thus, beginning in 2022, ATI will reflect an entity's earnings before interest and taxes only.

While the TCJA has special rules concerning the application of the limitation to passthrough entities, with the limitation generally applicable at the entity level, no guidance exists concerning computation of the limitation regarding a federal consolidated group.³ It should be noted that the congressional conference report does specify that "in the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."⁴ Despite this comment, however, the language in section 163(j) does not address this point and there is, as yet, no guidance under IRC section 1502 setting forth how the computation will be performed in a consolidated group context. Accordingly, it is now uncertain at the federal level whether the computation of ATI and the interest expense deduction limitation will be performed on a separate or a consolidated basis.

The business interest expense limitation generally does not apply to taxpayers with average annual gross receipts for the three preceding years of \$25 million or less.⁵

Computation of the Interest Limitation at the State Level

In most states, the corporate income tax base is based on a taxpayer's federal taxable income. However, in both combined-filing states and separate-filing states that conform to section 163(j), alternative computations may be needed to determine the interest expense limitation in each state if it is determined that the computation should be performed at the consolidated group level for federal income tax purposes. In separate-return states, a different computation will be needed to determine the interest expense limitation for each corporate taxpayer that files within the state. Furthermore, even in many combined-filing states, the state combined group may not be the same as the federal consolidated group, thus resulting in the need for additional interest expense limitation computations to adjust for the differences between the federal and the state group. Accordingly, while conformity to the IRC generally results in simplicity and efficiency at the state level, conformity to the new interest expense limitation will cause much more complexity, with the possibility that many separate computations will need to be performed for each state return. Due to the variations in the composition of state filing groups across the country, this state-by-state recomputation of the interest expense deduction limitation could be an administrative nightmare for multistate companies affected by section 163(j).

Use of Suspended Losses

At the federal level, interest expense that is disallowed can be carried forward indefinitely. Carryforward of this expense at the state level raises many issues, including ones concerning apportionment, change in composition of a combined group, and computational issues when IRC section 382 is triggered.

The apportionment issue that may occur is best explained with an example concerning a corporation that incurs an interest expense in a year when its State A apportionment percentage is 50 percent but, because of application of section 163(j) at the state level, the interest expense is suspended. The issue arises if the carryforward deduction is allowed to be used in a later year when the apportionment percentage has changed, for example, by decreasing to 10 percent or increasing to 90 percent. States will have to set rules determining how the interest expense will be computed in such carryforward year.

The NOL carryforward provisions may provide some guidance on how this issue should be addressed. Currently, most states use either of two methods for determining the use of NOL carryforwards at the state level — pre-apportionment or post-apportionment. Most states have post-apportionment rules whereby state NOL carryforwards are computed based on the taxpayer's apportionment percentage from the year in which the loss was incurred. Other states use a pre-apportionment method by which the amount of an NOL to be used in a carryforward year is based on the taxpayer's apportionment percentage in the carryforward year. If a state decides to conform to the new interest expense limitation rules, it will need to adopt rules concerning the apportionment of carried-forward interest in determining the state tax base. If a state chooses a post-apportionment method, taxpayers will need to track not only the amount of their suspended interest expense in such state, but also the years from which the interest is suspended and the apportionment percentage in effect for such years.

Another issue that arises at the state level concerns the federal impact of section 382 on the suspended interest expense. Section 382 provides that when there is a change in ownership of a taxpayer, the taxpayer may be limited in the amount of its losses from tax periods before the change that it can use to offset income from periods after the change. The TCJA provides that

this rule also applies to suspended interest expense.⁶

Many states conform to section 382, either specifically or through general conformity to the IRC. In states that ultimately choose to conform to the interest expense limitation, an issue may arise as to whether the section 382 limitation must be determined on a pre- or post-apportionment basis.

If a state were merely to conform to the current version of the IRC and not enact special rules concerning the application of section 382, there is a good argument that the *entire* amount of *unapportioned* interest permitted under section 382 could be used against state-*apportioned* income. This issue was addressed by an Alabama administrative law judge in *AT&T Corp. v. Alabama Department of Revenue* in the context of the application of the section 382 limitation on state NOLs.⁷ In *AT&T*, the ALJ acknowledged that because NOL carryforwards were applied on an apportioned basis, it made sense for the section 382 limitation to also be applied on an apportioned base; however, because Alabama had not issued rules providing for apportionment of the NOL, the taxpayer was allowed to use its full, unapportioned NOL to offset the amount of its Alabama-apportioned income.

Similarly, a Minnesota tax court determined that Minnesota's provision conforming to the section 382 NOL carryforward limitation did not require such limitation to be apportioned, even though NOLs were applied on a post-apportioned basis.⁸ In this case, the court noted that the Minnesota statute specifically required that the section 382 limitation be applied to income "before apportionment" and, as in *AT&T*, no method was provided for apportioning the limitation.⁹

Another wrinkle that could arise from a taxpayer's ability to carry forward suspended interest expense at the state level in a combined-return state concerns the possibility that the composition of a group with a suspended loss may change. Again, as with NOLs, states will have to provide guidance on how to split up any combined-group suspended interest expense among the members of the group, and to determine whether the other members of the consolidated group may use the interest carryforward brought in by a new entity.

Yet another issue could arise if a state allocates the suspended interest to different members of the group. This could cause the isolation of suspended interest expense that could not be used by the member to which the expense is allocated. The California NOL regime sheds some light on this issue. In California, the amount of an NOL to be carried forward is determined on a group basis but each member of the group is allocated a portion of the NOL in a given year based on its apportionment formula in that year. Each entity must then track its own loss carryforward. If a state adopts a similar regime for suspended interest expense carryforwards, the suspended interest expenses could get trapped with a member whose presence in that state has decreased since the interest deduction was incurred. This would be especially troubling if the amount of the interest expense limitation was computed on a combined basis, because in that case a disproportionate amount of the deduction could end up trapped in a particular entity.

Interaction With State Related-Party Addback Provisions

Another complication from the new federal interest expense limitation arises in states that have

related-party-interest addback provisions. For example, assume a corporation has \$1,000 of interest expense, with \$200 of such interest expense being suspended because of application of the new interest expense limitation at the state level. Now assume that \$400 of the corporation's \$1,000 in interest expense is paid to related parties and, thus, must be added back to the corporation's state tax base under the state's related-party-interest addback provisions. One issue that arises under this scenario is whether the \$200 of suspended interest expense is deemed to be related-party interest, with the result that the taxpayer would have to add back only \$200 of its related-party interest expense. If, however, none of the suspended interest is considered to be related-party interest, then \$400 would be added back to the state tax base under the related-party addback provision. This type of computation becomes even more complicated if only part of the related-party interest expense needs to be added back.

In addition to addressing the issue concerning application of any suspended interest expense to the related-party addback in the year in which the interest expense is disallowed, taxpayers will need to track any suspended interest expense on a going-forward basis, including determining how much of such suspended interest expense may be attributable to related-party interest that may be needed to be added back.

The interplay between the carryforward of suspended interest expense and the state's addback provisions may also raise constitutional issues at the state level concerning fair apportionment. Constitutional principles require that the tax imposed by a state must be "fairly related" to the taxpayer's activities in the taxing state.¹⁰ Now, assume the addback of a taxpayer's related-party interest expense is suspended in one year due to the disallowance of the taxpayer's interest expense deduction. If the addback is ultimately required in a year when the taxpayer's apportionment percentage is very different from the apportionment percentage when the taxpayer first paid the interest, there could be a Constitutional problem. Is the state income that results from the addback of the suspended interest "fairly related" to the taxpayer's business activities in the state in the year of the addback? Arguably, the answer is no.

Policy Implications

In making any policy decision concerning whether a state should conform to the federal interest expense limitation, state policymakers and legislators should remember that the suspended interest is a valid trade or business expense. There are already mechanisms to protect states from the deduction of a supposed interest expense that is not actually an interest expense, such as the performance of a debt-equity analysis, IRC section 385 regulations, and business purpose and economic substance principles. Furthermore, as discussed above, the states themselves already have anti-earning-stripping rules and mechanisms to deal with related-party interest, such as related-party addbacks and combination.

Furthermore, it can be argued that, just as states should not bear the cost of a federal provision that is designed to encourage specific tax behavior (that is, the new federal expensing provisions), the states should not reap a benefit from a federal provision designed to encourage particular tax behavior. This argument in favor of states' decoupling from section 163(j) becomes stronger when considering the significant burden of complying with section 163(j) on a multistate basis. Decoupling from the federal interest expense limitations will result in more streamlined state tax compliance. Furthermore, because the purpose of the interest expense limitation is to prevent earnings stripping at the federal level, in states where taxpayers can and

do use a worldwide reporting regime, the purpose of the anti-earnings-stripping provision would be moot.

Also, states frequently decouple from federal tax incentives, such as bonus depreciation or the federal provision delaying recognition of cancellation of indebtedness income, based on the rationale that a state should not bear the revenue loss attributable to a federal policy decision to encourage specific behavior. The same rationale arguably applies here — the states should not receive a benefit because of the federal government's policy decision to attempt to impose limits on the borrowing of funds by companies, especially in a situation in which conformity results in more complexity at the state level.

Importantly, it should be noted that while states may believe that there is some support for the adoption of the interest expense limitation rules at the state level based on the fact that some of these complex issues are already addressed regarding the carryforward of NOLs, such support is limited. There is a legitimate purpose for states to adopt NOL carryforwards while there is arguably little purpose for a state to conform to the interest expense limitation. The NOL carryover is designed to level a corporation's earnings between tax periods so that a loss can be used to offset a taxpayer's income, even if generated in a different tax period. This is important at both the state and federal level because the division of income and loss between tax periods can be arbitrary and, thus, a taxpayer should not have to bear a tax liability merely because its income and losses are generated in different tax periods. This policy is just as important at the state level as it is at the federal level. The interest expense deduction limitation, however, is an anti-earnings-stripping tool used by the federal government. It is imposed in an attempt to influence taxpayer's behavior, and states certainly can, and hopefully will, decouple from this interest expense limitation.

Conclusion

We hope that states will recognize the administrative and potentially constitutional challenges of conforming to section 163(j) and decouple from that provision, especially because the states already have protection against financing structures with tax-avoidance motives. Georgia has already done this, as the first state to enact legislation specifically decoupling from section 163(j).¹¹ Georgia's legislation conforms to the current IRC but explicitly decouples from section 163(j) and related provisions. Hopefully more states will follow in the footsteps of Georgia. We will stay tuned for more!

FOOTNOTES

¹ See OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4.

² Section 163(j)(1).

³ Section 163(j)(4).

⁴ Joint Explanation of the Committee Conference, H.R. 1, at 228 (2017).

⁵ Section 163(j)(3); and section 448. The \$25 million gross receipts test is determined pursuant to the test set forth in section 448, which is the same test used to determine whether a taxpayer can use a cash method of accounting. Section 448 provides that related entities that meet particular thresholds set forth in other provisions of the IRC (the work opportunity credit and particular employee benefit rules) should determine their qualifications for this exemption on an aggregated basis. These aggregation rules are complex and are broader than the federal consolidated filing rules (for example, the consolidated filing rules require 80 percent common ownership, while the aggregation rules for purposes of the interest expense limitation require only 50 percent common ownership). Thus, a federal consolidated group may have to include gross receipts of entities outside the group in determining whether the group is exempt from the interest expense limitation rules. Section 448(j)(3); section 448(c)(2); sections 52(a), (b); and sections 414(m), (o).

It seems likely that the same rules that apply at the federal group level should also apply at the state level, regardless of whether the state is a separate-return state or a combined-filing state with members of the combined group that are different from the members in the federal consolidated group.

⁶ Section 382(d)(1).

⁷ Administrative Law Division, No. 05-403 (2006).

⁸ *Express Scripts Inc. v. Commissioner of Revenue*, 8272 R (2012).

⁹ Interestingly, in *Express Scripts*, the Department of Revenue argued that “the section 382 limitation must be reduced by applying the taxpayer’s post-change year’s apportionment percentage to determine the limited amount of (apportioned) taxable net income that is eligible for a net operating loss deduction for those losses being carried forward from pre-change years.” The court rejected this argument, stating: “The Commissioner’s methodology of basing a taxpayer’s section 382 limitation amount on post-change actions by the new corporation results in a section 382 limitation that changes each year and would be, therefore, indeterminable at the time of the change of control. Under the Commissioner’s methodology, buyers and sellers would be unable to value NOLs because they would not know the apportionment percentages for future years.” This same rationale is also applicable to the section 382 interest expense limitation.

¹⁰ *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

¹¹ Virginia also passed legislation that effectively decouples from section 163(j) by specifically

not conforming with the provisions of the TCJA affecting tax liability for years beginning on or after January 1, 2018.

END FOOTNOTES

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